Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:
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X =

A =

B =

D1 =

D2 =

D3 =

D4 =

D5 =

IRA =

Year 1 =

z =

Dear :

This letter responds to your September 25, 2000, and subsequent correspondence, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated D1 and elected to be S corporation effective D2. On D3, X issued z shares of X to IRA, an individual retirement account for the benefit of A. B, as X's vice-president and chief financial officer, represents that A believed that as a retirement plan, IRA would be an eligible shareholder. X's attorney transferred the stock certificates of X to IRA. However, X's attorney did not inform X that an IRA is not an eligible shareholder.

In D4, another of X's shareholders attempted to direct his IRA to invest in X's stock. However, that shareholder's stockbroker informed that shareholder that an IRA is not an eligible S corporation shareholder. At that time, X contacted its accountant who confirmed that an IRA is an ineligible shareholder. Therefore, on D5, X repurchased all the shares issued to IRA.

B represents that for Year 1, A reported the income allocable to IRA from X on A's Form 1040, U.S. Individual Tax Return.

B represents that the circumstances resulting in the termination of X's S corporation election on D3 were inadvertent. B represents also that X and its shareholders did not intend to engage in tax avoidance or retroactive tax planning. X and each person who was or is a shareholder of X agree to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary with respect to such period.

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1)(B), as in effect for taxable years beginning on or before December 31, 1997, provided that a "small business corporation" cannot have as a shareholder a person (other than an estate, and other than a trust described in § 1361(c)(2) or an organization described in 1361(c)(6)) who is not an individual.

Rev. Rul. 92-73, 1992-2 C.B. 224, holds that a trust that qualifies as an individual retirement account under § 408(a) of the Code is not a permitted shareholder of an S corporation under § 1361.

Section 1362(d)(2)(A) provides that an election under § 1362(a) will be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that the termination shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, or (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination,

steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we hold that X's election was terminated on D3 because an ineligible shareholder held shares of X. We hold also that the termination of X's S corporation election was inadvertent within the meaning of § 1362(f).

We further hold that under the provisions of § 1362(f), X will be treated as an S corporation effective D3 to D5, provided X's election to be an S corporation was not otherwise terminated under § 1362(d). Accordingly, X's shareholders, in determining their federal tax liability, must include their pro rata share of the separately and nonseparately computed items of X under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by X to shareholders under § 1368. If X or its shareholders fail to treat X as described above, this ruling shall be null and void.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, no opinion is expressed on whether the original election made by X to be an S corporation was a valid election under § 1362.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X.

Sincerely yours,
JEANNE M. SULLIVAN
Assistant to the Chief
Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes